Internal Revenue Service

memorandum

CC:TL-[redacted]
Br2:CTSanderson

date: NOV 27 1990

to: District Counsel, San Diego W:SD
Attn: Jay Posedel

from: Assistant Chief Counsel (Tax Litigation) CC:TL

---

subject: [redacted]

This memorandum responds to your request for tax litigation advice dated October 9, 1990. You requested assistance to prepare arguments supporting the Service's position that assistance payments from the Resolution Trust Corporation (RTC) to [redacted] are taxable income.[1]

ISSUE

Whether advances from the RTC to [redacted] are Federal financial assistance subject to income tax under section 597 of the Internal Revenue Code of 1986, as amended.

CONCLUSION

The advances from the RTC to [redacted] are Federal financial assistance subject to income tax pursuant to section 597 of the Code. The advances are not loans for Federal income tax purposes. Even if they were, under section 597 [redacted] should treat the advances as items of ordinary income.

FACTS

[redacted] was a stock savings and loan association and a subsidiary of [redacted]. The bankruptcy court recently confirmed [redacted]'s chapter 11 plan of reorganization. The Service has submitted a claim as a creditor of [redacted] by virtue of [redacted]'s joint and several liability for the federal income taxes owed by [redacted] with whom [redacted] filed consolidated income tax returns. [redacted], now doing business as [redacted] but still part of [redacted]'s consolidated group, received over $[redacted] from the RTC between [redacted] and [redacted].

---

[1] "[redacted]" refers to either [redacted] or [redacted] (the bridge institution) as required by context.

On [redacted], the Office of Thrift Supervision (OTS) appointed the RTC as [redacted]'s conservator. In doing so, the OTS determined that [redacted] was substantially insolvent, had no access to alternative sources of capital, and could not replenish its capital through earnings. The RTC began advancing funds to [redacted] on [redacted], in exchange for interest bearing demand notes. [redacted] needed the advances to pay off loans from the [redacted] because [redacted] no longer qualified for [redacted] loans.

On [redacted], [redacted] was placed in receivership and the RTC appointed receiver. On that date, the RTC also transferred all of [redacted]'s assets and most of its liabilities to [redacted], a bridge institution. The RTC continued to advance funds to [redacted] through [redacted].[2]

DISCUSSION

Section 597 of the Code provides that taxpayers must treat Federal financial assistance as the Secretary of the Treasury directs in regulations. Federal financial assistance includes money or other property the RTC provides under section 21A of the Federal Home Loan Bank Act "regardless of whether any note or other instrument is issued in exchange therefor" (I.R.C. § 597(c) (emphasis added)).

Section 21A of the Federal Home Loan Bank Act[3] gives the RTC the same power to assist savings and loan institutions that the Federal Deposit Insurance Act gives the Federal Deposit Insurance Corporation (FDIC). Loans are within the ambit of FDIC assistance.[4]

[redacted] exists and holds certain assets and liabilities of [redacted] under the RTC's section 21A authority. The RTC's authority to assist [redacted] during its receivership, therefore, also is under section 21A. Even if the RTC's

---

[2] For a more detailed factual summary, see September 11, 1990, memorandum from Lynn Shields to Jay Posedel. RTC's appointments as conservator and receiver appear to be under the authority in section 21A(b)(4) of the Federal Home Loan Bank Act (12 U.S.C.A. § 1441a(b)(4) (1989)), by reference to section 11(d)(2) of the Federal Deposit Insurance Act (12 U.S.C.A. § 1821(d)(2) (1989)).

[3] 12 U.S.C.A. § 1441a(b)(4) (1989).

[4] Section 23(c)(1) of the Federal Deposit Insurance Act, 12 U.S.C.A. § 1823(c)(1) (1989).

assistance to [redacted] is a bona fide loan, it is still Federal financial assistance under section 597(c) of the Code.

As stated above, the Secretary of the Treasury has authority to issue regulations prescribing the treatment of Federal financial assistance. Furthermore, the May 22, 1989, House Ways and Means Committee Report on Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) allows Treasury to exercise its regulatory authority by issuing any administrative pronouncement of the Internal Revenue Service in lieu of regulations.[5] The Service issued such guidance on September 7, 1989, as Notice 89-102, 1989-2 C.B. 436. The Notice defines Federal financial assistance consistently with section 597 of the Code.[6] With exceptions not relevant here, the Notice generally requires taxpayers to take Federal financial assistance into account as an item of gross income.[7] This is consistent with the legislative history of section 597 which contemplates that "most financial assistance received by, or paid with respect to, financially troubled financial institutions would be treated as taxable."[8]

Under section 597 of the Code, the assistance the RTC provided [redacted] is Federal financial assistance notwithstanding [redacted] issuing its demand notes to the RTC. Under Notice 89-102, Federal financial assistance is an item of gross income unless a more specific provision of the Notice mandates other treatment. There being no provision in the Notice specifically discussing cash advances from the RTC in exchange for notes, [redacted] must include the advances in its gross income in the year it receives the payments.

Even if [redacted] could show that the assistance it received from the RTC was not given under section 21A of the National Housing Act and, therefore, was not Federal financial assistance under section 597, the cash advances from RTC in exchange for demand notes were not bona fide loans; thus, the advances would be taxable income to [redacted] under general tax principles (see

---

[5] House Comm. on Ways and Means, 101st Cong., 1st Sess., Report on the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 25 (Comm. Print 1989).

[6] 1989-2 C.B. at 438.

[7] Id.

[8] House Comm. on Ways and Means, supra.

I.R.C. § 61).[9] There are innumerable cases discussing whether purported loans are loans for federal income tax purposes.[10] Generally, a loan is an unconditional promise to pay a sum certain at a specified time. Furthermore, a purported loan is not a loan for federal income tax purposes if the lender reasonably would not expect repayment when it advanced the funds[11] or the debtor reasonably would not obligate himself for the amount of the loan.[12] The facts and circumstances at the

---

[9] We must use this argument carefully. The best statement of the proposition is that the advances were not bona fide loans. To avoid conflict with pre-FIRREA law, we should not argue the point as a debt v. equity issue, which could produce a conclusion that the advances were contributions to capital. The Service takes the position that, absent a statutory exclusion from income, pre-FIRREA assistance payments are income, not nonshareholder contributions to capital under section 118. Generally, the FDIC only may make assistance payments if assisting the institution costs less than liquidating it and paying the insured depositors. Because choosing to assist an institution instead of liquidating it gives a quantifiable benefit to the FDIC, assistance does not qualify as a nonshareholder contribution to capital under section 118 of the Code. Compare United States v. Chicago, Burlington & Quincy Railroad Co., 412 U.S. 401 (1973).

[10] For simplicity's sake, this memorandum will use the words "lender," "debtor," and "loan" in discussing transactions even though an analysis of the transactions for federal income tax purposes shows that those titles do not reflect the true economics of the transactions.

[11] See, e.g., In re Uneco, Inc., 532 F.2d 1204 (8th Cir. 1976); Road Materials Inc. v. Commissioner, 407 F.2d 1121 (4th Cir. 1969); Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968); Fischer et. al. v. United States, 441 F. Supp. 32 (E.D. Pa. 1977), aff'd, 582 F.2d 1274 (3d Cir. 1978); Thaler v. Commissioner, T.C. Memo. 1978-24, 37 T.C.M. 147 (CCH). See also Cuyuna Realty co. v. United States, 382 F.2d 198 (Ct. Cl. 1967); Wood Preserving Corp. of Baltimore v. United States, 347 F.2d 117 (4th Cir. 1965); Gilbert v. Commissioner, 248 F.2d 399 (2d Cir. 1957).

[12] See Estate of Franklin v. Commissioner, 544 F.2d 1045 (9th Cir. 1976); Roe et al. v. Commissioner, T.C. Memo. 1986-510, 52 T.C.M. 778 (CCH), aff'd sub nom. Sincleair v. Commissioner, 841 F.2d 394 (5th Cir. 1988), Young v. Commissioner, 855 F.2d 855 (8th Cir. 1988), and Haag v. Commissioner, 855 F.2d 855 (8th Cir. 1988). See also Karme v. Commissioner, 73 T.C. 1163 (1980), aff'd, 673 F.2d 1062 (9th Cir. 1982).

time of the advance, not the parties' later statements of their intent or belief, establish whether a reasonable expectation of repayment existed at the time of the loan. Each bona fide loan case lists slightly different criteria for determining whether an advance is a loan for federal income tax purposes. Some of the common criteria are as follows:

(1) Would independent, reasonable parties enter into the loan?

(2) Does the debtor have income or funds from which to repay the loan?

(3) Has the lender attempted to collect on the loan?

(4) Does the loan have a fixed maturity date?

(5) Are the lender's rights subordinate to those of other creditors?

(6) Does a formal debt instrument exist?

The most often recurring test for bona fide loans is whether independent, reasonable parties would enter into the loan. In fact, one case called the independent lender test the "acid test" for bona fide loans.[13] In [redacted]'s case, an independent lender clearly would not have made the loan. In fact, the RTC, relying on its authority to assist failed or failing institutions under section 21A of the Federal Home Loan Bank Act, made advances to [redacted] only after the [redacted], an ordinary course creditor for a savings and loan, refused to make loans to [redacted]. The RTC is not an "independent" creditor of [redacted], because the RTC would be liable to [redacted]'s depositors if [redacted] no longer could fund its operations.

In Estate of Franklin v. Commissioner,[14] the court questioned whether the debtor acted reasonably. The court suggests that at some point a lending transaction can become so nonsensical that the Service justifiably can disregard a note.[15] In [redacted]'s case, that point of nonsense comes when a federal agency lends over $[redacted] to an institution that another federal agency has declared insolvent and yet another federal agency has deemed an unacceptable credit risk.

---

[13] Fischer et. al. v. United States, 441 F. Supp. 32, 38 (E.D. Pa. 1977).

[14] 544 F.2d 1045 (9th Cir. 1976).

[15] Id at 1048.

[redacted] had no funds from which to repay the [redacted] advances. Unless [redacted] has become much healthier during its bridge institution period, it likely cannot afford to repay the RTC's advances. The OTS report for [redacted] indicates no "turn around" in [redacted]'s business fortunes.

A fixed maturity date[16] and the lender's attempts to collect payments[17] also are significant in determining the existence of a bona fide loan. In this case, [redacted]'s notes to the RTC do not have a fixed maturity date, but are demand notes with interest running but not due until the notes are called. It is unlikely the RTC will demand payment. [redacted] likely cannot fund its ongoing operations if the RTC calls the notes, because the OTS has expressed grave doubt about [redacted]'s ability to raise additional funds and no one else will provide funds to [redacted]. By calling the notes, therefore, the RTC would force itself to pay [redacted]'s depositors immediately, losing the advantage of selling [redacted] as a going concern. As the court in Thaler v. Commissioner suggested, a lender who also is running the business will not demand repayment to the detriment of the business.[18] Similarly, in Roe v. Commissioner,[19] the court noted that even "[r]ecourse debt should not be taken into account where, taking economic realities into account, there is no reasonable likelihood that the taxpayer actually will have to pay the debt."[20]

We do not know to what extent the RTC's rights are generally subordinate to those of other creditors. By virtue of deposit insurance, depositors are paid in full to the extent their deposits are insured. Furthermore, in a "depositor preference" state, [redacted]'s depositors would have the highest priority of its creditors. The RTC's advances are collateralized by all of [redacted]'s assets not already in use as collateral. Most likely these assets are already committed to the benefit of the

---

[16] In re Uneco, Inc., 532 F.2d 1204, 1208 (8th Cir. 1976); Road Materials Inc. v. Commissioner, 407 F.2d 1121, 1123 (4th Cir. 1969); and Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968).

[17] Thaler v. Commissioner, T.C. Memo. 1978-24, 37 T.C.M. 147, 151 (CCH).

[18] Id.

[19] T.C. Memo. 1986-510, 52 T.C.M. 778, 797 (CCH), aff'd sub nom. Sincleair v. Commissioner, 841 F.2d 394 (5th Cir. 1988), Young v. Commissioner, 855 F.2d 855 (8th Cir. 1988), and Haag v. Commissioner, 855 F.2d 855 (8th Cir. 1988).

[20] Id.

creditors; however, further information may be needed in this regard.

[redacted] does meet some of the tests for establishing a bona fide loan. Formal debt instruments exist, although they would not be conclusive evidence the advances were actually loans even if they were "meticulous" in form.[21] Also, [redacted] did proffer its mortgage loans and other assets not otherwise pledged as collateral for the loans. The collateralization of the loans is more nominal than real, however, because as conservator or receiver of [redacted], the RTC had the right to take, use, or dispose of [redacted]'s assets anyway.[22] In offering collateral to the RTC, [redacted] really did not grant the RTC a right it otherwise did not have.

SUMMARY

In spite of the existence of debt instruments, [redacted] cannot establish that the advances it received from the RTC were bona fide loans. The RTC made advances to [redacted] when it was insolvent and when its usual creditors clearly refused to lend funds. The receivership established the fact that the OTS did not expect [redacted] to generate sufficient income or other funds to pay existing creditors. Therefore, the RTC would not have intended that the advances be repaid absent unexpected, extraordinary circumstances. Therefore, unconditional promises to repay loans did not, in fact, exist.

Finally, even if the advances from the RTC to [redacted] are loans for federal income tax purposes, they are still Federal financial assistance as defined in section 597 of the Code. Under Notice 89-102, Federal financial assistance is an item of gross income to the failed or failing institution.

MARLENE GROSS

By: _____
ALFRED C. BISHOP, JR.
Chief, Branch 2
Tax Litigation Division

---

[21] Fin Hay Realty Co. v. United States, 398 F.2d 694, 697 (3d Cir. 1968); Thaler v. Commissioner, T.C. Memo. 1978-24, 37 T.C.M. 147, 151-52 (CCH).

[22] See section 11(d)(2) of the Federal Deposit Insurance Act (12 U.S.C.A. § 1821(d)(2) (1989)).